RELATIVE INCOME HYPOTHEIS

INTRODUCTION

- James Duessenberry
- Relative income hypothesis states that, consumption of an individual is not the function of his absolute income but of his relative position in the income distribution in the society
- Thus, consumption is not only based on the absolute income of the individual but also its relative income
- Consumption behavior is not independent but interdependent
- Income consumption relations are irreversible

Demonstration effect

- People have a tendency to imitate consumption habits of other people
- This tendency of a family to imitate the consumption habits of rich neighbors or ‘ joneses’ is called demonstration effect
- It is also known as Duessenberry effect
- It shows consumption functions are inter dependent
- Through Demonstration effect, Duesenberry explains the social character of consumption pattern

Ratchet effect

- High level of consumption is irreversible
- Ratchet effect means that households will not reduce their consumption much, as their income falls
- This is partly due to demonstration effect
- This is also partly due to the fact that they become accustomed to their previous higher level of consumption, and it is quite hard and difficult to reduce their consumption expenditure when their income has fallen
- They maintain the earlier consumption level by reducing savings

Features of Relative Income Hypothesis

- Consumption is proportional to relative income
- If relative income falls, APC rises
- If relative income rises, APC falls
- In the long run, APC =MPC

Relative income hypothesis states that as income increases consumption function curve shifts above so that APC remains constant

Permanent Income Hypotheis

Introduction

- Milton Friedman (1957)
- According to Friedman, consumption is determined by long-term expected average income rather than current income
- It is the long-term expected income which Friedman calls Permanent Income
- Permanent income may be earned from human and non-human wealth
- Human wealth- labour income
- Non- human wealth consist of physical and financial wealth

- An individual prefers a smooth consumption flow per day rather than plenty of consumption toady and little consumption tomorrow
- Thus, people plan their consumption on the basis of expected average income over a long period which he calls as Permanent Income
- $C^P = kY^P$
- k is the proportion of permanent income consumed
- k depends on: rate of interest (i), the proportion of non-human wealth to human wealth (w), the desire to add to ones' own wealth (u)
- k= f(i, w, u)

Permanent and Transitory Income

- Measured income is the actual income that a family receives during short period
- Measured income consists of: permanent income and transitory income
- A transitory income is a temporary income that is not going to persist in future
- Measured income may be less than or greater than permanent income depending on transitory income
- $Ym = Yp + Yt$
- Yt positive implies $Ym > Yp$
- Yt negative implies $Ym < Yp$

- According to Friedman, Permanent income is equal to last year's income plus a proportion of change in income occurred between the last year and the current year
- $Yp = Yt\text{-}1 + a\ (Yt - Yt\text{-}1)$
- Thus, permanent income hypothesis is based on adaptive looking or backward looking expectation